18 October 1979

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

VIA : Director, National Foreign Assessment Center

SUBJECT : SCC Meeting on 25 October 1979 (S)

1. Action Requested: None, for information only. (U)

2. Background: Jim Cochrane of the NSC Staff has given us the following information on the SCC Meeting scheduled for 25 October:

-- The meeting is for principals only, including yourself and:

Brzezinski
Duncan
Miller
Brown
Vance
Strauss (possible)

-- No papers will be presented. (S)

3. We have also learned that you will be asked to make a brief presentation at the SCC Meeting on the linkage between oil production and pricing policies of Arab countries on the one hand and the Mid-East peace talks on the other.

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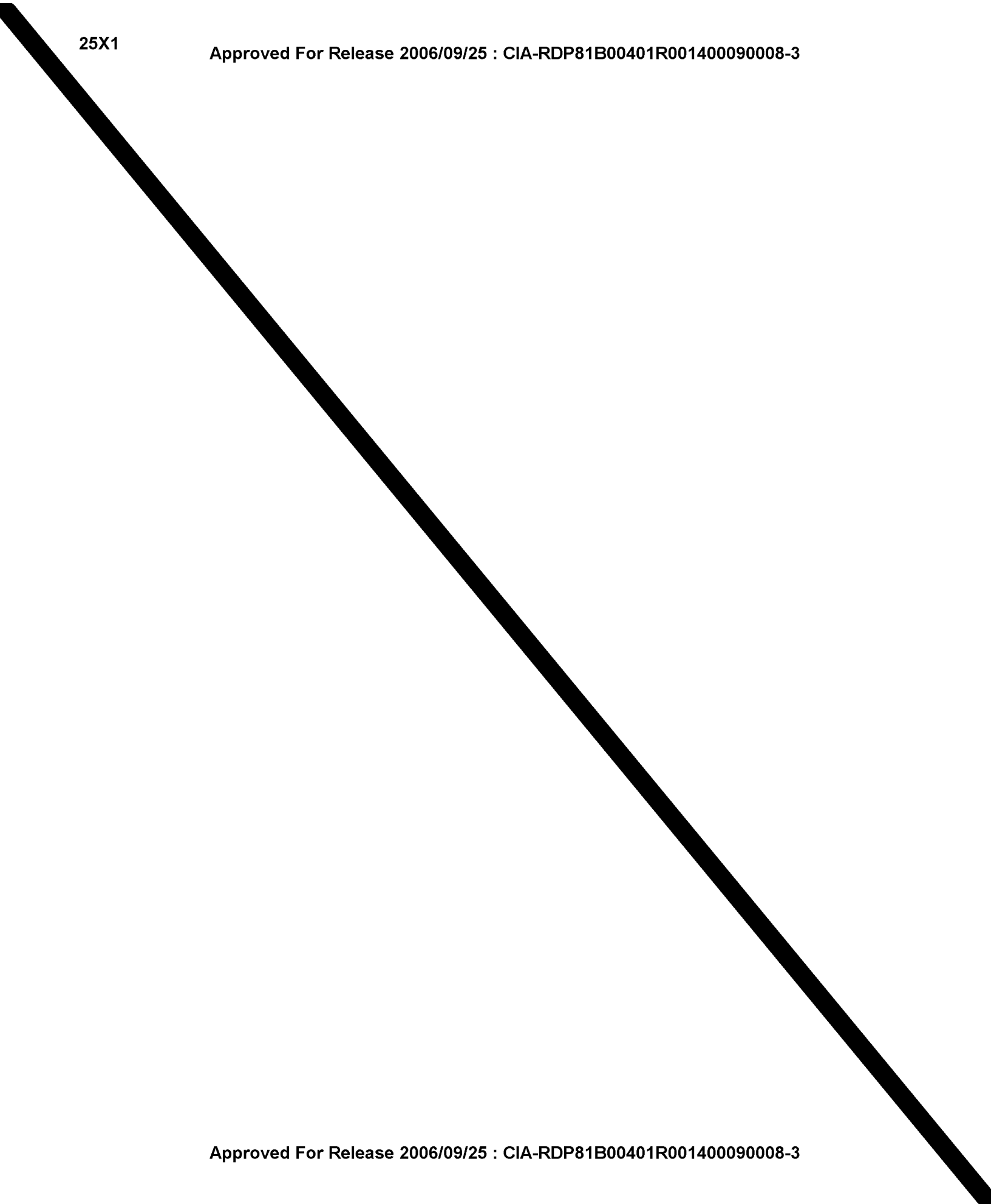

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SPOT MARKET DEVELOPMENTS (U)

Spot market prices for both crude oil and products continue to escalate despite Saudi Arabia's announced intention to maintain its oil output at 9.5 million b/d through the fourth quarter. Strong demand for stockbuilding fueled by an uncertain supply outlook and disruptions of traditional distribution channels have caused the scramble for existing supplies that is pushing up the spot price. OPEC countries, for their part, view the widening spread between official and spot prices as evidence of market pressures. Consumer governments, although asking companies to report spot market transactions, apparently are not discouraging efforts to ensure against OPEC disruptions or cutbacks in contracted deliveries by making spot purchases. (U)

Use of the Spot Market

The spot market is primarily a residual market, balancing supply and demand at the margin. It serves the needs of those companies with a particular crude oil or product in excess of their requirements and those who run short. Because the prices of spot market crude and products were often competitive with the prices of contract crude and products, many firms, particularly in West Germany and Japan, have traditionally relied on that market for much of their supplies. Also, as the major oil companies have lost their unique access to crude, their customers have been forced into the spot market. Traders and speculators also use the spot market, but they do not have a large effect on price levels. While sales can be in the form of straight purchases or complicated international swaps, there is no registration of participants or volume, and price quotations are only estimates. (U)

Spot market prices normally oscillate in a narrow band around contract prices. During periods of tight supply, however, spot price movements become volatile and often exceed contract prices by sizable amounts. (U)

The price that a company is willing to pay for a cargo of crude oil on the spot market is determined by netting back spot market product prices. The typical refiner will calculate the potential revenue from the refined product yield of a barrel of crude and subtract transport and refining costs to arrive at a net back or crude offer price. In cases where the spot crude prices exceed the net back price, companies will buy products instead of crude. This situation is happening now in the European spot market. (U)

Producing countries view spot prices as being indicative of the disparity between official prices and the real market value of their oil. The recent increases in spot prices have again triggered a series of producer price hikes. As one producing official recently stated, "the spot market is pulling official prices along." (U)

Recent Market Developments

Spot market oil prices resumed their upward spiral in late September. Persian

Gulf crudes are now selling for $36-38 per barrel in the Rotterdam market with light African crudes selling about $2 per barrel higher. These prices represent nearly a $15 premium above official prices and an increase of $4-5 over the past few weeks. Traders expect prices to top $40 per barrel before yearend. Spot product prices have also strengthened with gas oil and gasoline prices up $25 a ton and heavy fuel oil up $15-20 per ton from late September prices. (U)

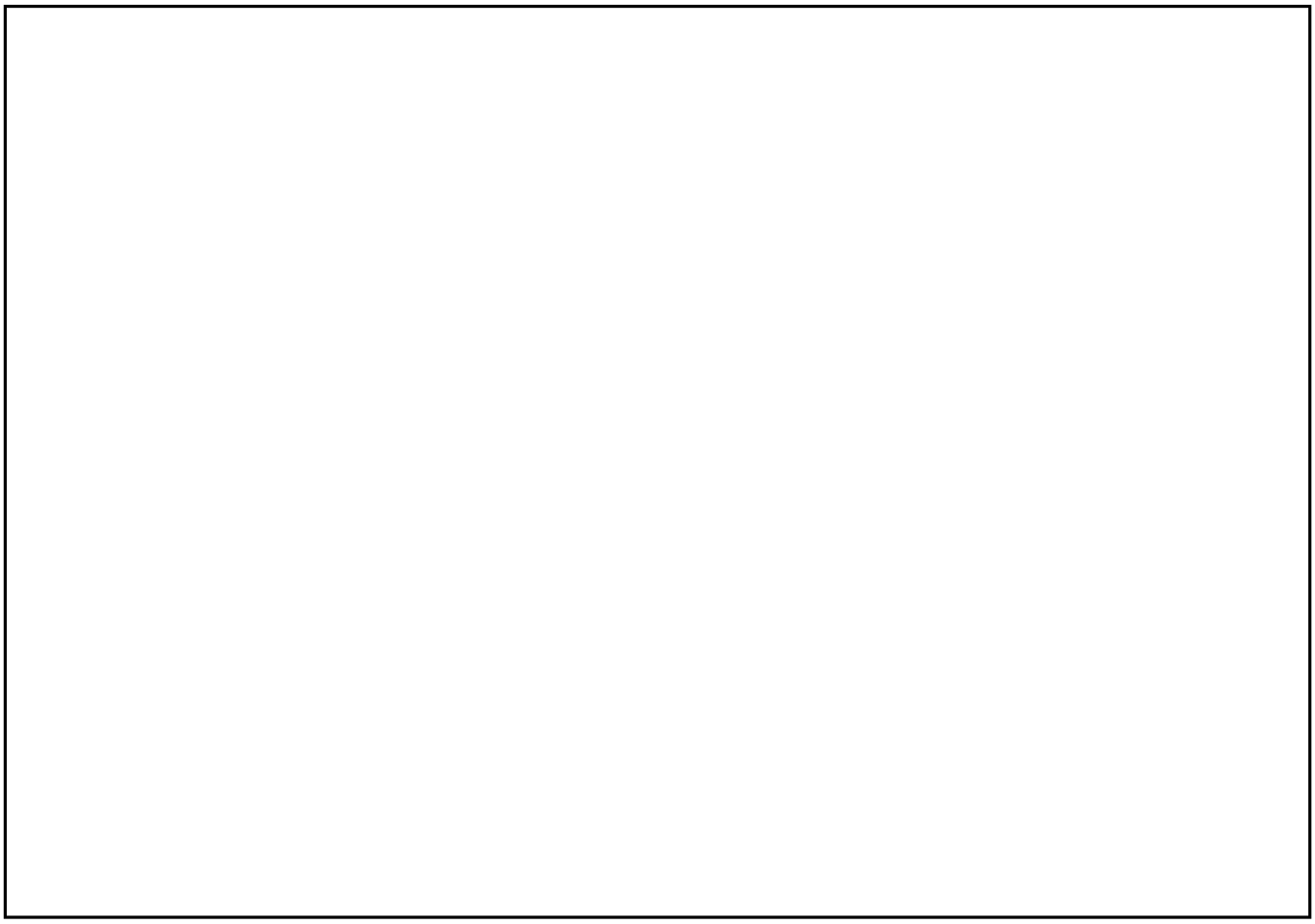
During the past nine months, the volume of oil traded on the spot market has expanded significantly. Although comprehensive data are unavailable, traders estimate that recent spot market sales account for 15-20 percent of total OPEC production outside Saudi Arabia. [redacted] normally spot sales amount to 600,000 b/d of products and 1.5 million b/d of crude—about 3-5 percent of non-Communist oil demand. (C NF) 25X1

A major factor behind the escalation in spot market transactions has been the disruption of normal distribution channels stemming from OPEC decisions to reduce the amount of oil sold to major international companies. The producer moves reflect their desire to take advantage of the high spot prices. (U)

[redacted] 25X1

As a result of reduced direct supplies from the producers, some majors have been reducing or eliminating sales to third party customers. These latter have been forced to seek supplies elsewhere, opening new distribution channels that have been partially filled by direct purchase contracts with oil-producing nations and through spot market

purchases. Major oil companies themselves have also been forced into the spot market to fulfill contract commitments and maintain supplies to their downstream facilities. In addition, escalating oil prices and the tight market have encouraged speculative buying in the spot market. (U) 25X1



Monitoring the Market

With prices escalating and increasing volumes of crude oil being traded, consuming countries have become increasingly concerned about spot market activities. Some feel that close monitoring of spot market transactions will dampen wild price fluctuations and reduce OPEC incentives to boost official prices and engage in spot market sales. In our view, however, the underlying cause of the price runup is that oil supplies are inadequate to meet demand. In these circumstances any attempt to restrain spot prices by limiting company spot purchases will have little if any impact. Obtaining wide agreement will be difficult even among the developed countries. Moreover, the larger LDCs would almost certainly refuse to go along.(U)

The most ambitious attempt to monitor the spot market is being made by the International Energy Agency. Member nations are trying to develop an oil price

register that will provide spot crude and produce price "transparency." The theory behind the register is that buyers will refrain from paying spot prices that are well above official prices if governments can readily identify prices, volumes, and parties to the transaction. The register reportedly would also show which OPEC members are breaking the cartel's pricing policy in an effort to get more for their oil. (U)

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Approved For Release 2006/09/25 : CIA-RDP81B00401R001400090008-3

The Oil Market Outlook

The oil market remains delicately balanced. Free World oil production stands at record levels, no spare capacity exists in OPEC or elsewhere, and demand remains firm. In these conditions, any disruptions or production cuts, whether in Iran, Saudi Arabia, or one of the smaller oil producers will lead to a tightening of the market such that further large price increases will be unavoidable. Indeed, even without such a disruption, prices could continue rising into 1980, so strong is the pressure by consumers to meet their current needs and build security stocks against the supply reductions that many believe to be possible. (U)

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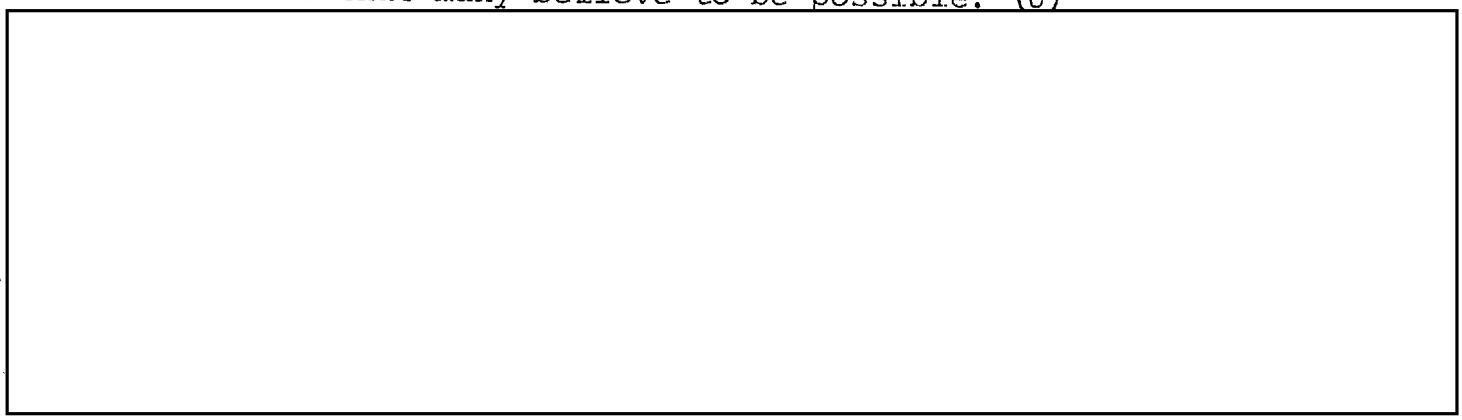


Buyer apprehension over future supply availability, together with expectations of further OPEC price increases is adding to market pressures by driving oil companies and other stockholders to seek larger than normal inventories. Recent changes in the distribution system is also boosting demand for inventory. The major change is that the oil-producing nations are marketing more of their output directly instead of through the major oil companies. These changes have increased demand for inventories as the buyers take upon themselves at least part of the storage function that they once left in the hands of the major companies. (U)

Recent Developments

The taut supply-demand balance and heightened buyer uncertainty about future supplies are responsible for the recent sharp climb in spot market prices. After stabilizing

during most of the third quarter, Persian Gulf crudes are now moving at $36-$38 a barrel while African crudes are selling at $2 a barrel higher. These prices represent about a $15 premium above official prices and an increase of some $3-$4 over the past few weeks. Spot product prices have also rebounded recently. Contract price hikes announced during the past few weeks by several OPEC countries are likely to spread during the remainder of 1978 and be officially increased at the December OPEC meeting. (U)

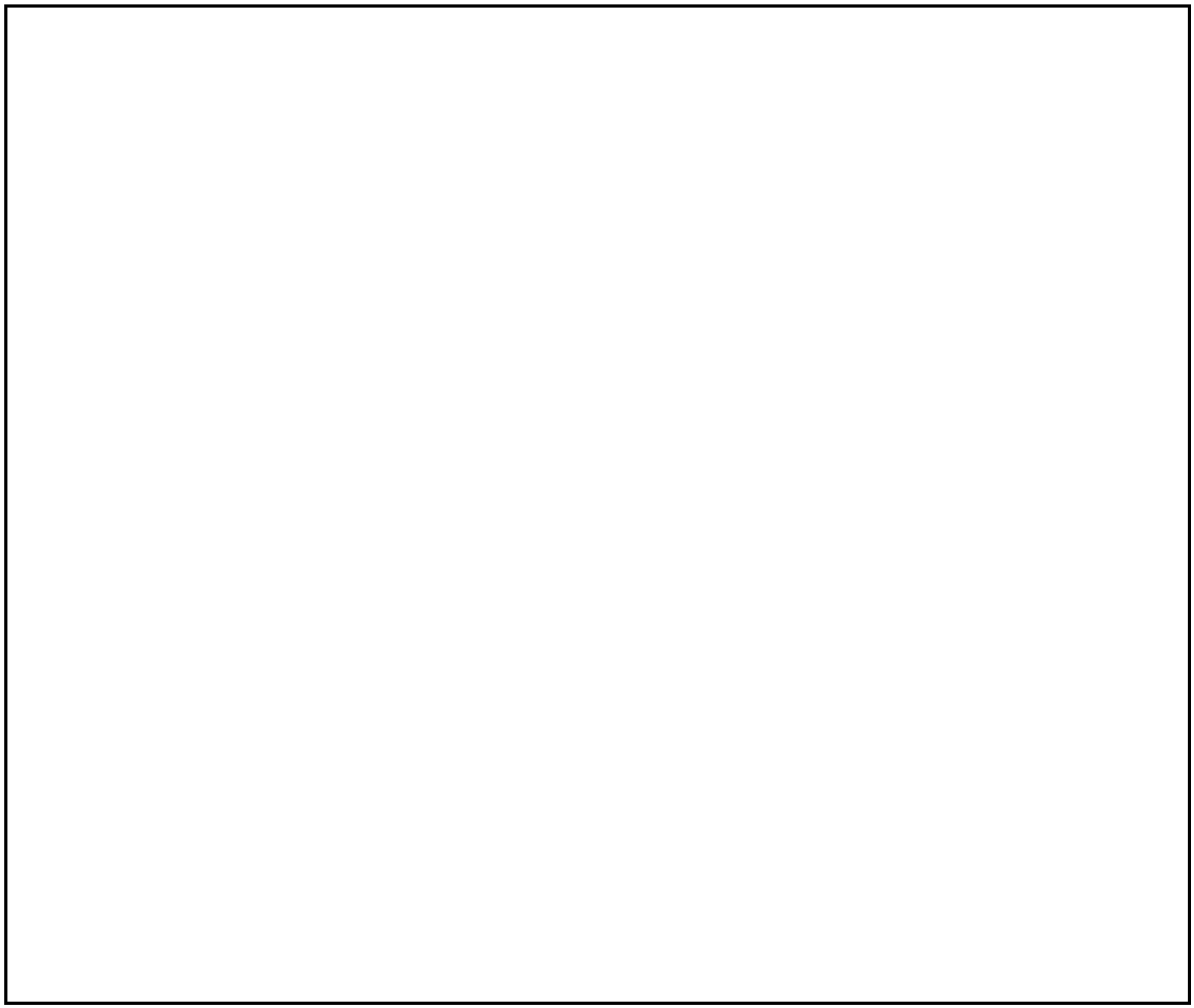
Preliminary, partial data indicate Free World oil consumption held firm in third-quarter 1979, rising by 1 percent compared with year earlier levels. This compares with a 3 percent increase in the first quarter and a 1-2 percent rise in the second quarter. In the third quarter declines in US oil consumption -- mainly gasoline usage -- apparently continued to be more than offset by increases in most foreign countries. Overall gasoline consumption through mid-year was down slightly in the Big Seven industrial countries because of the US decline. Increased availability of natural gas has kept a tight lid on light fuel oil consumption in the Big Seven while heavy fuel oil use has remained about unchanged with sharp declines in the US roughly offset by increased usage in Western Europe. (U)

While oil consumption has held firm, the widely anticipated third-quarter increase in Free World supplies failed to materialize. Despite the 1 million b/d increase in Saudi output. This gain was nearly offset by declines elsewhere leaving total OPEC production up only 100,000 b/d between the second and third quarters. By the end of the quarter sizeable production cuts -- 200,000 b/d or more -- had occurred in Iran, Nigeria and Algeria.

25X1

These production and consumption patterns permitted a rougly normal inventory accumulation rate in third-quarter 1979. By the end of September, however, our tentative calculation suggest that stocks were still about 3 percent below normal levels; given changes in distribution arrangements and precautionary stock preferences of buyers, the inventory situation was probably less satisfactory than these calculations suggest. As for product inventories,

US distillate stocks at the end of the third quarter stood at 229 million barrels some 4 percent above year earlier levels. Gasoline stocks are also up by about 4 percent, while residual fuel oil stocks are up by about 14 percent. Crude oil stocks are roughly the same as year earlier levels after excluding government held stocks. (U)



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Aside from uncertainties stemming from production policies in key countries, the supply outlook is clouded by the threat of political problems, especially in Iran. As it is, continued political instability in Iran -- which

Major Developed Countries: Oil Stocks on Land

Million barrels end of period

	1977				1978				1979		
	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Qtr 1	Qtr 2	Qtr 3
United States[1/]											
Total	1087	1195	1307	1303	1150	1155	1216	1211	1064	1128	1218
Crude	299	334	334	340	346	333	321	310	318	329	321
Products	788	861	973	963	804	822	895	901	746	799	897
of which:											
Gasoline	262	256	256	258	260	220	217	238	239	232	228
Distillate Fuel Oil	142	179	253	250	138	158	221	216	113	144	229
Residual	71	72	88	90	62	72	81	86	72	79	92
Western Europe											July
Total	1106	1185	1259	1255	1080	1118	1194	1186	1061	1146	1158
Crude	372	432	407	433	371	412	396	412	380	433	420
Products	734	753	852	822	709	706	798	774	681	713	738
of which:											
Gasoline	118	109	100	101	101	96	86	94	102	102	101
Distillate Fuel Oil	255	275	335	323	257	244	315	296	222	240	260
Residual	231	243	290	268	229	247	283	274	230	277	290
Japan[1/]											August
Total	337	372	386	390	371	382	377	364	335	346	364
Crude	201	207	203	201	215	216	201	192	186	190	189
Products	136	165	183	189	156	166	176	172	149	156	175
of which:											
Gasoline	13	16	12	15	14	16	14	14	14	14	13
Distillate Fuel Oil	22	36	50	52	25	35	54	41	23	32	47
Residual	26	30	31	34	30	32	29	31	29	30	28

1/ Excluding government owned stocks.

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is interfering with what little field maintenance that was going on -- has prevented output from staying at the 4.0 million b/d the government said it wanted. Production fluctuated widely in third-quarter 1979 averaging 3.6 million b/d; some industry observers believe output was appreciably lower. In any event, the wide variations in Iranian output and continued reports of sharp reductions have left buyers extremely skittish about the near-term future. [redacted] 25X1

No spare capacity exists elsewhere to compensate for any planned or unplanned production cuts in these countries. Mexican output will be increasing, but the gain is expected to approximate only 300,000 b/d through fourth-quarter 1980. UK production will increase by similar amounts if output is held at maximum rates. These gains will be partly offset by further slippage in US output and some reduction in net sales from Communist countries. Recent price increases for oil -- as well as gold -- will make it easier for the Soviets to reduce oil export volume to the West without incurring hard currency shortages. As it is, Soviet oil shipments to the West in first-half 1979 were roughly one quarter below the same period last year. (U)

Lower Oil Consumption Expected

The anticipated economic slowdown in industrialized countries along with higher prices and government conservation measures is expected to keep oil consumption growth slow through 1980. Oil companies and consulting firms generally project Free World oil consumption to average about 52 million b/d in 1980 if supplies are available -- roughly 1 percent more than estimated oil consumption in 1979 on an increase of 500,000 b/d. This projection is roughly consistent with OECD economic growth of 1 to 1.5 percent next year and assumes virtually all the growth in OECD energy consumption is satisfied by non oil sources. The increase in Free World oil consumption of 500,000 b/d reflects increased usage in OPEC and non-OPEC LDC's.

Within the OECD, US oil consumption can be expected to decline while increases are expected in Western Europe and Japan where the economic slowdown is not expected to be as severe. Our oil consumption scenario assumes that US real GNP declines nearly 1 percent next year. For Western Europe and Canada real GNP growth of 2 percent is assumed while a 3.5 percent GNP gain is used for Japan.

Supply Demand Balance

To assess near-term market conditions, we have examined two supply scenarios. In our optimistic supply case

Case Summary: Free World Stocks on Land

	Normal Based on historical trends 3/	Billion barrels Stocks 1/ Case 1	Stocks 1/ Case 2		Supply (Shortfall) or Surplus 2/ Case 1	Case 2
1979	Billion Barrels			1979	Million b/d	
September	4.1	4.0	4.0	4th Qtr.	.5	.5
December	4.0	3.9	3.9			
1980				1980		
March	3.7	3.6	3.5	1st Qtr.	0	(1.0)
June	4.0	3.9	3.7	2nd Qtr.	.4	(1.4)
September	4.3	4.3	3.9	3rd Qtr.	.3	(1.6)
December	4.2	4.2	3.5	4th Qtr.	0	(2.0)

1/ At end of month indicated.
2/ The shortfall or surplus is calculated as the difference from the normal stock change in a quarter. Production is lagged one month to allow for delivery (i.e., production in June is supply in July).
3/ Assumes quarterly oil stock movements continue at the historical rates of 1971-77. During this period stocks rose at a faster rate than consumption, resulting in a rise in stocks both in absolute terms and measured in days of consumption. Normal inventory levels for third-quarter 1979 through fourth-quarter 1980 are calculated by applying average quarterly stock changes in the period 1971-77 to June and September 1978 actual stock levels, then averaging the two results and adjusting for government stock changes.

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Free World Consumption, Supply and Stocks

	Estimated Actual		Case 1					
	1979				1980			
	I	II	III	IV	I	II	III	IV
	Million b/d							
Consumption[1/]	55.6	49.3	48.6	53.4	56.2	49.8	49.1	53.9
Supply	51.0	52.6	52.8	53.0	52.8	52.8	53.0	53.1
	Billion Barrels							
Stocks on Land[2/]	3.4	3.7	4.0	3.9	3.6	3.9	4.3	4.2

	Estimated Actual		Case 2					
	Million b/d							
Consumption[1/]	55.6	49.3	48.6	53.4	56.1	49.8	49.1	53.9
Supply	51.0	52.6	52.8	53.0	51.4	50.9	51.0	51.1
	Billion Barrels							
Stocks on Land[2/]	3.4	3.7	4.0	3.9	3.5	3.7	3.9	3.5

1/ Assumes consumption grows at 1 percent over estimated year earlier levels. Excludes refinery gain in the United States.
2/ End of period.

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Free World Supply Case 1 [1/]

million b/d

	1979				1980			
	I	II	III	IV	I	II	III	IV
Total	51.0	52.6	52.8	53.0	52.8	52.8	53.0	53.1
OPEC	30.3	31.8	31.9	31.9	31.7	31.7	31.7	31.7
Saudi Arabia	9.5	8.5	9.5	9.5	9.5	9.5	9.5	9.5
Iran	1.1	4.0	3.6	3.6	3.6	3.6	3.6	3.6
Iraq	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Kuwait	2.4	2.2	2.2	2.2	2.0	2.0	2.0	2.0
Nigeria	2.4	2.4	2.2	2.2	2.2	2.2	2.2	2.2
United Arab Emirates	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
of which								
Abu Dhabi	(1.4)	(1.4)	(1.4)	(1.4)	(1.4)	(1.4)	(1.4)	(1.4)
Dubai	(.4	(.4	(.4	(.4)	(.4)	(.4)	(.4)	(.4)
Venezuela	2.4	2.3	2.3	2.3	2.2	2.2	2.2	2.2
Qatar	.5	.5	.5	.5	.5	.5	.5	.5
Neutral Zone	.6	.6	.6	.6	.6	.6	.6	.6
Libya	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Indonesia	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Gabon	.2	.2	.2	.2	.2	.2	.2	.2
Ecuador	.2	.2	.2	.2	.2	.2	.2	.2
Algeria	1.1	1.1	.9	.9	.9	.9	.9	.9
Natural Gas Liquids	0.8	0.8	0.8	0.8	0.9	0.9	0.9	0.9
Non-OPEC	20.7	20.8	20.9	21.1	21.2	21.2	21.3	21.4
United Kingdom	1.5	1.7	1.7	1.8	1.8	1.9	2.0	2.0
Norway	.4	.4	.4	.4	.5	.5	.5	.5
Mexico	1.5	1.6	1.7	1.8	1.8	1.9	1.9	2.0
United States	10.2	10.2	10.1	10.1	10.1	10.0	10.0	10.0
Other	6.1	6.1	6.3	6.4	6.4	6.4	6.5	6.6
Net Communist Exports	1.0	.8	.7	.6	.6	.5	.4	.3

* Because of rounding, components may not add to the totals shown.

1/Assumptions - Kuwait and Venezuela reduce output in first-quarter 1980 as planned, other OPEC countries maintain production at current levels and non-OPEC countries produce at near capacity.

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Free World Supply Case 2[1/]

million b/d

	1979				1980			
	I	II	III	IV	I	II	III	IV
Total	51.0	52.6	52.8	53.0	51.4	50.9	51.0	51.1
OPEC	30.3	31.8	31.9	31.9	30.2	29.7	29.7	29.7
Saudi Arabia	9.5	8.5	9.5	9.5	8.5	8.5	8.5	8.5
Iran	1.1	4.0	3.6	3.6	3.6	3.6	3.6	3.6
Iraq	3.5	3.5	3.5	3.5	3.0	3.0	3.0	3.0
Kuwait	2.4	2.2	2.2	2.2	2.0	1.5	1.5	1.5
Nigeria	2.4	2.4	2.2	2.2	2.2	2.2	2.2	2.2
United Arab Emirates	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Of which								
Abu Dhabi	(1.4)	(1.4)	(1.4)	(1.4)	(1.4)	(1.4)	(1.4)	(1.4)
Dubai	(.4	(.4	(.4	(.4)	(.4)	(.4)	(.4)	(.4)
Venezuela	2.4	2.3	2.3	2.3	2.2	2.2	2.2	2.2
Qatar	.5	.5	.5	.5	.5	.5	.5	.5
Neutral Zone	.6	.6	.6	.6	.6	.6	.6	.6
Libya	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Indonesia	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Gabon	.2	.2	.2	.2	.2	.2	.2	.2
Ecuador	.2	.2	.2	.2	.2	.2	.2	.2
Algeria	1.1	1.1	.9	.9	.9	.9	.9	.9
Natural Gas Liquids	0.8	0.8	0.8	0.8	.9	.9	.9	.9
Non-OPEC	20.7	20.8	20.9	21.1	21.2	21.2	21.3	21.4
United Kingdom	1.5	1.7	1.7	1.8	1.8	1.9	2.0	2.0
Norway	.4	.4	.4	.4	.5	.5	.5	.5
Mexico	1.5	1.6	1.7	1.8	1.8	1.9	1.9	2.0
United States	10.2	10.2	10.1	10.1	10.1	10.0	10.0	10.0
Other	6.1	6.1	6.3	6.4	6.4	6.4	6.5	6.6
Net Communist Exports	1.0	.8	.7	.6	.6	.5	.4	.3

Because of rounding, components may not add to the totals shown.

1/ Assumptions - Saudi Arabia, Iraq, Kuwait and Venezuela reduce output in first quarter 1980, other OPEC countries maintain production at current levels and non-OPEC countries produce at near capacity.

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we assume that third-quarter oil supplies are maintained through 1980 (Case 1). This case implies that, Kuwait and Venezuela reduce output by 200,000 b/d and 100,000 b/d respectively in first-quarter 1980 as planned, and non-OPEC countries continue to produce at expected capacity. In our second scenario (Case 2) we assume that Saudi Arabia, Kuwait and Iraq reduce output from the combined current level of 15.2 million b/d to an average of 13.1 million b/d in 1980. Under this scenario, which we consider to have a higher probability of occurring than our first scenario, non-Communist oil supplies average about 51 million b/d in 1980 down about 1 million b/d from estimated 1979 levels. In both scenarios, Iranian production is maintained at 3.6 million b/d -- a critical assumption with all the risks on the downside. (U)

If we assume Free World oil consumption grows by 1 percent trhough yearend 1980 then, our optimistic supply scenario would have to be approximated to maintain normal inventory levels. Even with normal inventory patterns, however, spot shortages of specific products in certain countries could occur because of the changing pattern of oil distribution and the reduced ability of the major companies to fine tune regional and product needs. Given the delicate balance and supply uncertainty, companies would continue to want to build above normal stocks as a hedge against future supply disruptions or to speculate on higher prices. (U)

Under our more likely supply scenario, a 1 million b/d supply shortfall would develop in first-quarter 1980 rising to 2 million b/d by yearend. Strong upward price pressures would be unavoidable. Because oil companies would try to keep inventories at normal levels or higher, oil consumption would have to be restrained in 1980 to about 51 million b/d implying a decline of about 1 percent in oil consumption from estimated 1979 levels. This adjustment process would likely include more rationing by companies, higher prices, and slower economic growth. Government conservation measures to date will likely contribute little to restrain consumption. Conditions under this supply scenario would be similar to those prevailing in the wake of the Iranian crises. (U)

Product Market Pressures

Even if the high supply scenario materialized and OECD crude oil requirements remain unchanged -- or even decline slightly -- intermittent shortages of light oil products could emerge within OECD group. Shortages are

certain to develop if any Persian Gulf production cuts are concentrated on light crudes. As it is, light crudes supplies are shrinking because of production declines in Nigeria, Libya, Venezuela, Algeria and the United States. (U)

Product Demand

Demand for lighter oil products will remain relatively strong over the period through 1980 unless OECD real economic growth slows much more severely than now expected. By and large, these products -- gasoline, jet fuel, and diesel and light fuel oil -- are not sensitive to the business cycle. Given the light-heavy mix in consumption patterns, the projected 1980 gain in total Free World oil usage, implies an increase in light oil product requirements of 1-2 percent, since heavy fuel use is expected to decline. Whether light crude supplies plus available secondary refining capacity can support an increase in demand, particularly for gasoline without regional shortages cropping up is highly uncertain. Given national consumption patterns, the United States seems most vulnerable to regional shortages; Western Europe, however, could also experience product mix problems, since secondary refining capacity is limited. (U)

The key uncertainty is the strength of any rebound in US gasoline consumption next spring. Even with further price hikes, US consumption should recover to near 1978 levels in 1980 according to most observers. If this occurs, consumption during the 1980 peak driving season would exceed this year's level by perhaps 600,000 b/d. Unless constrained by supply availability, gasoline consumption should maintain its long-term growth trend of 3-4 percent in Western Europe and Japan, where automotive fleets will continue to expand while fuel efficiency standards will remain unchanged. (U)

We expect the market for light fuel oil to be sluggish over the next year or so, as natural gas substitution continues in Western Europe. Harsh winter conditions, however, could give a strong push to demand. Analysis of past weather and oil consumption data indicates that if all countries experienced a repeat of the coldest winter in the past 14 years, non-Communist oil consumption would be about 200,000 b/d -- mostly light fuel oil -- above what it would be under normal weather conditions during the heating season. A repeat of the warmest winter would reduce demand by a similar amount. The effect on the oil market would be more

severe if abnormally cold weather occurred early in the heating season, when future oil demand and weather conditions for the remainder of the winter are uncertain, than at the end of the heating season. (U)

While supply availabilities and continuing heating demand promise to keep most product markets tight, considerable slack could emerge in heavy fuel oil demand next year if industrial output in the Big Seven countries declines and if crude supplies are maintained at present levels. Substitution of other fuels will also help reduce demand for heavy fuel oils in several foreign countries, with government programs having been instituted in the United States, France, Italy and Japan to replace oil with coal in the generation of electricity. Completion of planned additions to electric power capacity from nuclear plants would also result in reduced demand for heavy fuel oil in the Big Seven countries next year. During 1980, we expect an additional 300,000 b/d oil equivalent of nuclear capacity to come on stream in Western Europe; the United States and Japan can each expect additions to 100,000 b/d oil equivalent if schedules are met. Whether this additional capacity actually replaces existing oil-fired plants depends on the growth in demand for electricity. (U)

Distribution Problems

With producing countries selling increasing amounts of oil directly, bypassing the major international companies the ability of the distribution system to allocate supplies evenly among countries and fine tune regional and product needs is reduced. Reduced supply availability to the majors has forced them to cuback or eliminate sales to third parties and affiliates. Consequently the growing uncertainties over future supplies via normal supply channels has led to a scramble to line up oil supplies by an increasing number of buyers in the market. (U)

Countries with governments' or companies active either in seeking contracts with producing countries or in the spot market have tended to receive more oil than countries with less aggressive purchases. Moreover, the increased number of buyers in the market probably increases the demand for inventories as the buyers unsure of future supplies take upon themselves at least part of the storage function that was once left in the hands of major companies. (U)

Sweden, Belgium and Ireland are becoming directly involved in oil acquisition, and New Zealand is also considering entering the market. Such long time state buyers as Italy, France, Spain, Greece have also been particularly active in recent months. The majors have sharply cut their supply of crude oil to Japans indepedent refiners. Consequently, the independents, which account for just under half of Japans refinery capacity have been forced to shift to the spot market and to move direct deals. This scramble will likely intensify particularly if supplies are cutback. (U)

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SPOT MARKET DEVELOPMENTS (U)

Spot market prices for both crude oil and products continue to escalate despite Saudi Arabia's announced intention to maintain its oil output at 9.5 million b/d through the fourth quarter. Strong demand for stockbuilding fueled by an uncertain supply outlook and disruptions of traditional distribution channels have caused the scramble for existing supplies that is pushing up the spot price. OPEC countries, for their part, view the widening spread between official and spot prices as evidence of market pressures. Consumer governments, although asking companies to report spot market transactions, apparently are not discouraging efforts to ensure against OPEC disruptions or cutbacks in contracted deliveries by making spot purchases. (U)

Use of the Spot Market

The spot market is primarily a residual market, balancing supply and demand at the margin. It serves the needs of those companies with a particular crude oil or product in excess of their requirements and those who run short. Because the prices of spot market crude and products were often competitive with the prices of contract crude and products, many firms, particularly in West Germany and Japan, have traditionally relied on that market for much of their supplies. Also, as the major oil companies have lost their unique access to crude, their customers have been forced into the spot market. Traders and speculators also use the spot market, but they do not have a large effect on price levels. While sales can be in the form of straight purchases or complicated international swaps, there is no registration of participants or volume, and price quotations are only estimates. (U)

Spot market prices normally oscillate in a narrow band around contract prices. During periods of tight supply, however, spot price movements become volatile and often exceed contract prices by sizable amounts. (U)

The price that a company is willing to pay for a cargo of crude oil on the spot market is determined by netting back spot market product prices. The typical refiner will calculate the potential revenue from the refined product yield of a barrel of crude and subtract transport and refining costs to arrive at a net back or crude offer price. In cases where the spot crude prices exceed the net back price, companies will buy products instead of crude. This situation is happening now in the European spot market. (U)

Producing countries view spot prices as being indicative of the disparity between official prices and the real market value of their oil. The recent increases in spot prices have again triggered a series of producer price hikes. As one producing official recently stated, "the spot market is pulling official prices along." (U)

Recent Market Developments

Spot market oil prices resumed their upward spiral in late September. Persian